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Fitch Rates California's $1B GOs 'A+'; Upgrades $38.5B GOs to 'A+'

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Fitch Ratings-New York-09 June 2006: Fitch Ratings assigns an 'A+' rating and Stable Outlook to the following general obligation (GO) bonds of the state of California, which will sell competitively on June 14:

--$700 million various purpose GO bonds;
--$311.8 million GO refunding bonds.

Fitch also upgrades the rating on approximately $38.5 billion state of California outstanding GO bonds to 'A+' from 'A', and revises their Outlook to Stable from Positive (see details below).

The rating upgrade reflects the breadth of California's continuing economic recovery, strong revenue performance, and continued progress in reducing fiscal imbalances. Revenues this year are well ahead of estimates, driven by higher personal and corporate income taxes, resulting in near break-even operations in fiscal 2006. The fiscal 2007 proposed budget, revised in May, prudently forecasts much of the recent revenue growth as nonrecurring, while applying significant resources toward paying down prior obligations. While the budget is not yet finalized, legislative contention appears to be minor. Nevertheless, despite the revenue momentum, a structural imbalance remains in fiscal 2007 and beyond, albeit reduced from previous projections, and the proposed budget would retain only small balances, leaving the state vulnerable to capital gains and real estate volatility. Other challenges include spending pressures driven in part by voter-approved initiatives, particularly for education. Debt levels are expected to remain moderate, providing capacity to address significant capital needs.

Major tax revenues dropped $13 billion in fiscal 2002, primarily from reduced personal income taxes from capital gains and stock option losses. Spending was not correspondingly reduced, leading to deficits and a cash flow crisis relieved through one-time measures, internal and external borrowing, and, ultimately, the issuance of approximately $11 billion deficit bonds. Improvement has occurred, primarily through rebounding revenues including 17% and 16% growth in personal income taxes in fiscal years 2005 and 2006, respectively. Corporate taxes are estimated to have increased 25% and 19% over the same period. Fiscal 2006 general fund revenues are now projected to be nearly $8 billion or 9.4% over the original budget estimate and to increase 12.2% over the prior year. Capital gains and stock options, which plummeted to 7% of general fund revenues from nearly 25% prior to the downturn, are estimated to have climbed to 13% of fiscal 2006 general fund revenues. Gains from real estate transactions are estimated to constitute a significant component.

Fiscal 2007 revenue projections, at $94.5 billion before transfers, are conservative, with growth of 2.2% over the upwardly revised estimates for this year. Personal income and corporate taxes increase only 3.0% and 1.5%, respectively. On the spending side, the budget proposal is expansive, with forecast growth of 9.1% to $101 billion, including proposed internal and external debt prepayments. Spending growth uses up the majority of the estimated $8.8 billion reserve remaining from fiscal 2006 and leaves a fiscal 2007 budget reserve of $2.2 billion. This includes $472 million in the Budget Stabilization Account created by Proposition 58, and a $1.7 billion budget reserve, although there are several potential claims on these monies.

Excluding $3 billion in debt prepayments, the fiscal 2007 operating deficit is $4.1 billion, although other non-recurring spending is included. The projected operating deficit in the out year, fiscal 2008, is $3.5 billion or less than 4% of revenues. When the original fiscal 2006 budget was passed, the out-year operating gap was projected at $7.5 billion.

California's economy continues to expand in all regions, including Northern California, which bore the brunt of the last recession. The state's employment growth now exceeds the U.S., with 2005 up 1.8% over the prior year, compared to 1.5% nationally. The trend continues in 2006, with employment up 1.5% in April, compared to 1.4% nationally, although growth in construction employment slowed to 2.5% in April, the slowest pace in more than two years. State personal income grew 6.0% in 2005, compared to 5.6% growth for the U.S. The proposed 2007 budget forecasts continued, albeit modest, economic growth, with employment and personal income growing 1.5% and 5.8%, respectively. The residential real estate market began cooling in the second half of 2005, with sales and permits dropping. The budget anticipates further declines through fiscal 2007 in sales, permits, and construction employment.

Net tax-supported debt totals $54.8 billion, a moderate 4.1% of personal income. Amortization is below average, with 41% of GO debt retired in 10 years. The governor and legislature agreed on a $68 billion strategic growth plan that envisions $37.3 billion in debt issuance for transportation, K-12 and other capital needs over 10 years. If approved by voters in November, the state's debt burden would increase, but would remain moderate.

Today's GO rating actions also affect the veterans GO and Cal-Mortgage Loan Insurance Division ratings (both of which are upgraded to 'A+', with a Stable Rating Outlook). Moreover, lease obligations issued by the following agencies are upgraded to 'A' from 'A-', with a Stable Rating Outlook.

--Public Works Board (except for those issued for the Regents of the University of California);
----Franchise Tax Board;
--East Bay State Building Authority;
--Los Angeles State Building Authority;
--Oakland State Building Authority;
--Riverside County Financing Authority;
--Sacramento City Financing Authority;
--San Bernardino Joint Powers Financing Authority;
--San Francisco State Building Authority;
--Golden State Tobacco Securitization Corporation (series 2005A).

The various purpose GO bonds are expected to mature Sept. 1, 2006, 2011-2017, and 2026-2035. The GO refunding bonds are expected to mature Sept. 1, 2006-2030. The bonds are callable beginning Sept. 1, 2016, at par.

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